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Supreme Court of the United States

October Term, 1958

No. 811

MID-SOUTHERN FOUNDATION,
Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

PETITION FOR WRIT OF CERTIORARI

To the United States Court of Appeals for the Sixth Circuit

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COMMISSIONER OF INTERNAL REVENUE,
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PETITION FOR WRIT OF CERTIORARI

To the United States Court of Appeals for the Sixth Circuit

Mid-Southern Foundation, organized and existing under the laws of Tennessee providing for the organization of corporations for the general welfare and not for profit, petitions the Supreme Court of the United States to issue a writ of certiorari to the United States Court of Appeals for the Sixth Circuit to review its judgment entered in the above-entitled case on December 13, 1958.

OPINIONS BELOW

The opinion of the Tax Court of the United States (R. 90a) is reported in 28 T.C. 918. The opinion of the United States Court of Appeals for the Sixth Circuit is reported in 262 F.(2d) 134. By order dated March 14, 1959, Mr. Justice Potter Stewart, upon application of counsel for petitioner, extended the time within which a petition for a writ of certiorari might be filed to and including April 7, 1959.

JURISDICTION

The proceeding before the Court of Appeals in which said judgment was entered was brought under the provisions of Sections 7482 and 7483 of the Internal Revenue Code of 1954, Title 26 U.S.C., Sections 7482 and 7483. The jurisdiction of the Supreme Court is invoked under Title 28 U.S.C., Section 1254(1) and Title 26 U.S.C., Section 7482.

QUESTION PRESENTED

May a Federal income tax statute, enacted for the purpose of taxing excessive profits attributable to the economic impact of the Korean War, be construed so as to create artificially "excessive profits" which do not exist with the result that there is thereby imposed an "excess profits" tax on a corporation which had a net loss as determined and recognized by the Commissioner of Internal Revenue in his process of ascertaining the "net income" of the corporation subject to the corporation normal tax and surtax?

STATEMENT

Mid-Southern Foundation is the transferee of Madison Avenue Corporation, a commercial Tennessee corporation, and as such is liable for the Federal income taxes due from Madison Avenue Corporation for the taxable years ended December 31, 1950, December 31, 1951, and the period ended June 10, 1952.

The Commissioner of Internal Revenue determined that Madison Avenue Corporation owed deficiencies in income taxes (excess profits taxes) as follows:

Year	*Deficiency*
12-31-50	$ 8,176.74
12-31-51	$21,160.18
1-1-52 to 6-10-52	$ 404.99

The Commissioner, by a statutory notice, asserted such deficiencies in income taxes (excess profits taxes) against Mid-Southern Foundation, which sought a re-determination thereof by the Tax Court of the United States in a proceeding which focused the controversy on the proper method of computing the excess profits tax credit of Madison Avenue Corporation. The Tax Court sustained the Commissioner. (R. 90a.) The United States Court of Appeals for the Sixth Circuit, one judge dissenting, affirmed the Tax Court by a final judgment. (R. .)

The petitioner, in contesting the tax liability as proposed with respect to its transferor, Madison Avenue Corporation, has consistently adhered to the proposition that the decision herein must turn on the interpretation of Section 437(c) of the Internal Revenue Code of 1939 (26 U.S.C. 1952 ed. Sec. 437(c)).

Such Section defines "equity capital" as follows:

> SEC. 437. INVESTED CAPITAL CREDIT.
>
> * * * * *
>
> (c) Definition of Equity Capital.—The equity capital of the taxpayer as of any time shall be the total of its assets held at such time in good faith for the purposes of the business, reduced by the total of its liabilities at such time. * * *

The proper construction of the statutory language defining "equity capital" is of controlling significance because the determination of the excess profits tax credit of a corporation involves a series of complex computations directed at ascertaining, among other things, the net capital addition or reduction for the taxable year. In arriving at the net capital addition or reduction it is important to discover the amount, if any, by which "equity capital" (as that term is defined in Section 437 (c) of the Internal Revenue Code of 1939) of the taxpayer at the beginning of the taxable year exceeds or is

less than the "equity capital" at the beginning of the taxpayer's first excess profits tax taxable year.

The Commissioner of Internal Revenue in the lower Courts urged that the petitioner's complaint should be directed at Section 433(a) of the Internal Revenue Code of 1939 (26 U.S.C. 1952 ed. 433(a)), the provision thereof relating to the prescribed adjustments to the normal tax income for the purpose of arriving at the excess profits tax net income rather than to the method of computing the excess profits tax credit.

The petitioner has never felt that an attack on the provisions of Section 433(a) of the Code of 1939 was either appropriate or justified; on the contrary, the petitioner's transferor adhered to the provisions of Section 433(a) in filing its excess profits tax return, feeling confident that the application of the excess profits tax credit computed in accordance with what was believed to be the proper construction of the statute would establish the correct amount of the excess profits tax liability. In conformity with this approach, the tax return of Madison Avenue Corporation for the year 1950 reflected an excess profits tax liability of $7,832.15 and the return for the year 1951 reflected an excess profits tax liability of $9,988.97. The tax return for the period January 1, 1952, to June 10, 1952, did not state any excess profits tax liability.

Thus, to arrive at the amount of the excess profits tax credit, the measure of the capital reduction was sought in the proceedings in the lower Courts. The liabilities of the taxpayer exceeded its assets at the beginning of the calendar year 1951 and at the beginning of the period January 1 - June 10, 1952.

The Commissioner contended that the excess of liabilities over assets at the beginning of the year ended December 31, 1951, and at the beginning of the period Janu-

ary 1 - June 10, 1952, created a "negative" or "minus" equity capital, which should be the measure of the capital reduction. The petitioner contended in the Tax Court, and contends here, that the "equity capital" of the taxpayer can only be diminished to the point where it ceases to exist, that is, to zero, and that there is no such thing as "minus equity capital." For the period January 1 - June 10, 1952, the application of the Commissioner's theory produces the result that the taxpayer did not owe any corporation income tax by reason of having an actual net loss from operations of $391.95. but owed excess profits taxes of $404.99.

REASONS FOR GRANTING THE WRIT

The decision of the Tax Court of the United States, as affirmed by the Court of Appeals, determines an important question of Federal law to the end that, it is respectfully submitted, the expressed intent and philosophy of the Congress is thwarted and therefore the question presented should be but has not been settled by this Honorable Court.

The determination of the Commissioner of Internal Revenue, if permitted to stand, will strike at the very foundation of the income tax laws, because the Commissioner has evolved a theory that abandons the fundamental income tax and economic concept that an income tax is levied on the "profits" derived from the operation of a business; here the Commissioner's theory works to the detriment of a taxpayer but the same theory, as is demonstrated herein, can operate to permit a taxpayer to escape the just and proper measure of its tax liability.

The Excess Profits Tax Act of 1950, like the previous Excess Profits Tax Acts, was adopted by Congress during a period of great national strain and anxiety and, like the previous Excess Profits Tax Acts, is almost intolerably obtuse and complex. Perhaps this is inherent

in a Congressional enactment which is directed not only at producing needed revenue for a monumental military effort but also at expressing a profound philosophical concept. This philosophical concept, which runs through the Congressional enactment like a crystal clear stream occasionally obscured by the underbrush and vegetation of confusing and cloudy verbiage but never completely disappearing from sight and retaining throughout its clear purity, is that it was the purpose of Congress to reach corporations with excessive profits attributable to the Korean conflict, but not to impose a fiscal penalty on corporations which do not have excessive profits or no profits at all.

It is only necessary to turn to the published reports of the Congress to find expressed the underlying philosophy of the Congress. In House of Representatives Report No. 3142, 81st Congress, 2nd Session (Internal Revenue Bulletin, Cumulative Bulletin 1951-1, page 187), it is stated:

> One of the main objectives in imposing an excess profits tax is to reach corporate profits which have been swollen by the increased tempo of the economy. An excess profits tax selects for additional tax those corporations whose profits are higher than they probably would have been in the absence of hostilities and a large military budget.

and at page 188—

> This bill has the effect of imposing an excess profits tax rate of 75 percent. This can be compared to an excess profits rate of 85½ percent at the end of World War II after allowance is made for the 10 percent postwar refund provided for by that tax. However, the combined rate of the corporate income and excess profits taxes under your committee's bill cannot exceed 67 percent of the corporation's net income.

In Senate Report No. 2679, 81st Congress, 2nd Ses-

sion (Internal Revenue Bulletin, Cumulative Bulletin 1951-1, page 240), it is stated:

> One of the main advantages of an excess profits tax in periods of large military expansion is that it selects for additional tax those corporations whose profits are higher than they probably would have been in the absence of hostilities and a large military budget. * * * In addition, your Committee's bill provides an over all limitation so that the income tax and excess profits tax together will not take more than 60% of any taxpayer's income.

It would appear that the philosophy of Congress as reflected by the Committee Reports quoted from hereinabove provides the only sound governing principle for the interpretation and application of the Excess Profits Tax Act of 1950.

In the present situation, for the year 1951 the normal tax and surtax plus the excess profits tax determined by the Commissioner and aggregating $100,254.82 is 68.10% of the normal tax and surtax net income of $147,217.39, and for the short period ended June 10, 1952, the excess profits tax of $404.99 determined by the Commissioner is obviously many times the net loss determined for the normal tax and surtax. Certainly, this result would be abhorrent to the sponsors of the Congressional enactment.

The narrow issue presented is whether the equity capital of Madison Avenue Corporation, at the beginning of the taxable year 1951 and the beginning of the taxable period January 1 - June 10, 1952, may be an amount less than zero.

An important element in computing the excess profits credit herein is the amount of the capital reduction of the particular taxable year and to determine this fact it is necessary, among other things, to ascertain the amount, if any, by which the equity capital (as defined in Section

437(c) of the Internal Revenue Code of 1939) at the beginning of the particular taxable year exceeds or is less than the equity capital of the taxpayer at the beginning of its first taxable year.

The definition of equity capital as found in Section 437(c) of the Internal Revenue Code of 1939 provides the appropriate starting point. The Section referred to is in part as follows:

> SEC. 437. INVESTED-CAPITAL CREDIT.
>
> * * * * *
>
> (c) Definition of Equity Capital.—The equity capital of the taxpayer as of any time shall be the total of its assets held at such time in good faith for the purposes of the business, reduced by the total of its liabilities at such time. * * *

When liabilities exceed assets then equity capital ceases to exist because by its very terms equity capital means a positive and actual capital. To say that when liabilities exceed assets a "negative equity capital" is created is not only a contradiction in terms but is repugnant to ordinary common sense.

A corporation whose liabilities exceed its assets may be an insolvent corporation, but certainly it is not possessed of "capital-positive" or "capital-negative."

In the trial in the Tax Court the petitioner, in attempting to make clear and graphic the divergence of views with respect to the computation of the excess profits credit, offered and there were received in evidence Exhibits 22, 21, and 18 which appear at pages 82a, 83a, 86a, 87a, 88a and 89a of the Record.

Since the loss year ended June 10, 1952, has been emphasized herein, it is believed appropriate to examine first Petitioner's Exhibit 22 with respect to such year. It will be noted that at line 13 the petitioner and the Commissioner agree that the total assets at the begin-

ning of the taxable year amounted to $981,092.56 and that at line 14 the parties also agree that the total liabilities amounted to $2,123,406.73. On line 15 the petitioner; believing that logic and common sense supports the view that when liabilities exceed assets the inevitable result is an absence of equity capital, reflects that fact by a zero, whereas the Commissioner takes the view that where liabilities exceed assets there is created a negative quity capital.

Line 17 reflects the petitioner's views that capital can be reduced only by the extent that it actually existed before the reduction, whereas the Commissioner takes the position that the reduction in capital must be the sum of the equity capital as it existed and the artificially conceived "negative equity capital."

It would seem that the opinion of the Tax Court in the instant case is in direct conflict with its opinion in the case of *Thomas Paper Stock Company*, 22 T.C. 1294.

The opinion of the Tax Court in the present case and the opinion of the Tax Court in the *Thomas Paper Stock Company* case make reference to Section 437(c) for the definition of "equity capital." This common definition should be interpreted in the same way, whether base period or taxable year capital additions or reductions are involved. This basic definition of equity capital without refinement or elaboration appears as an integral factor in the following Sections of the 1939 Code:

Section 435(f)(1)	Section 436(a)(1)
Section 435(f)(1)(A)	Section 436(b)(1)(A)
Section 435(g)(3)(B)	Section 436(b)(1)(B)
Section 435(g)(4)(B)	Section 441(a)
Section 435(g)(9)(B)(i)	Section 441(j)

It is inconceivable that the basic definition of equity capital could be interpreted ten different ways, depending on the Section of the Code involved.

It is believed that the Tax Court in the *Thomas Paper Stock Company* case reasoned realistically when it stated:

> The Commissioner is right in holding that Congress, in using the terms "equity capital" • • • had in mind actual capital as opposed to deficit or minus quantities. • • •
>
> The fact Congress did not expressly state that where the computation of either item (equity capital and base period capital) resulted in a minus figure it should not be used in computing base period capital additions is not significant since only positive amounts would normally be considered as existing capital of a business.

In the instant case the Commissioner's "negative equity capital" theory works to the disadvantage of the taxpayer. In a situation involving a company whose liabilities exceeded its assets at the beginning of the first taxable year, but which improved its financial position, the "negative equity capital" theory would provide an unwarranted and unrealistic advantage tax-wise.

This is illustrated by the following hypothetical computation in which particular figures are placed on the appropriate lines on "Schedule EP-2(B).—Taxable Year Capital Addition or Reduction" of "Schedule EP (Form 1120), U. S. Treasury Department," the very same form followed by the Commissioner in reflecting his computationus with respect to Madison Avenue Corporation. The columns headed "Per Petitioner" and "Per Commissioner" identify the positions of the parties under the contention of the Commissioner in the instant case.

Schedule EP-2(B).—Taxable Year Capital Addition or Reduction

Line No.			Per Petitioner	Per Commissioner
1.	Equity capital at beginning of first taxable year ending after June 30, 1950:			
	(a) Total assets	$100,000		
	(b) Less: Total liabilities	200,000	$ 0	$(100,000)
2.	Equity capital at beginning of the taxable year:			
	(a) Total assets	$300,000		
	(b) Less: Total liabilities	200,000	$100,000	$ 100,000
3.	Borrowed capital at beginning of first taxable year ending after June 30, 1950		$ 0	$ 0
4.	Average daily amount of borrowed capital for the taxable year		$ 0	$ 0
5.	Average daily amount of money and property paid in during the taxable year for stock, or as paid-in surplus, or as a contribution to capital		$ 0	$ 0
6.	Excess, if any, of line 2 over line 1		$100,000	$ 200,000
7.	75 percent of excess, if any, of line 4 over line 3		$ 0	$ 0
8.	Average daily capital addition (sum of lines 5, 6 and 7)		$100,000	$ 200,000

It is thus apparent that anomalous results can be obtained by adopting the Commissioner's "negative equity capital" theory; and it is submited that such results, one in favor of a taxpayer in the instance of capital addition, and one against a taxpayer in the instance of capital reduction, are equally absurd.

But the Commissioner says that if Congress had intended to preclude a "negative equity capital" in a situation in which liabilities exceeded assets it could have done so by using the words "but not below zero" which were inserted in Section 435(f) of the Internal Revenue Code of 1939 (26 U.S.C. 1952 ed. 435(f)) by Section 506(c)(1) of the Revenue Act of 1951, C 521, 65 Stat. 452.

It is submitted that a discriminating examination of Section 435(f) of the Code of 1939 points up the fact that the Commissioner's argument is specious.

Section 435(f)(1) of the Internal Revenue Code of 1939 provides:

> SEC. 435. EXCESS PROFITS CREDIT—BASED ON INCOME.
>
> • • • •
>
> (f) Capital Additions in Base Period.—
>
> (1) Definition of yearly base period capital—For the purposes of this subsection, the yearly base period capital for any taxable year shall be the sum of the equity capital (as defined in section 437(c)) at the beginning of such taxable year and an amount equal to 75 per centum of the daily borrowed capital (as defined in section 439(b)) for the first day of such taxable year, reduced (but not below zero) by the sum of—
>
> • • •

It will be seen that the definition of equity capital set forth in Section 437(c) of the Code of 1939 is adopted as a basic factor and that *from such equity capital* as so defined reduction may be made but not to the point of reducing the equity capital below zero. Congress, in the amendment made by the Revenue Act of 1951, did not say that where the liabilities of a corporation exceeded its assets its *equity capital* should not be reduced below zero or be a "negative equity capital" because it was apparent to Congress that equity capital existed only in the situation where assets exceeded liabilities. Contrary to the

Commissioner, the Congress at no time felt that it was necessary to modify the basic definition of equity capital expressed in Section 437(c) of the Code of 1939 by providing that in instances where liabilities exceeded assets the reduction of assets by liabilities could not be brought below zero. It is respectfully submitted that the Congress never contemplated that any one would ever contend that the definition of equity capital of Section 437 (c) of the Code of 1939 envisages the creation of a "minus equity capital" where liabilities exceed assets.

It is urged that the infallible guide to the proper construction of Section 437(c) of the Code of 1939 is the expressed intent and philosophy of the Congress at the time of the enactment of the Korean War Excess Profits Tax Act.

In *Helvering v. New York Trust Co., Trustee*, 292 U.S. 455, 464-465, 54 S.Ct. 806, 808, 78 L.Ed. 1361, this Court said:

> But the expounding of a statutory provision strictly according to the letter without regard to other parts of the act and legislative history would often defeat the object intended to be accomplished. Speaking through Chief Justice Taney in Brown v. Duchesne, 19 How. 193, page 194, 15 L.Ed. 595, this court said: "It is well settled that, in interpreting a statute, the court will not look merely to a particular clause in which general words may be used, but will take in connection with it the whole statute (or statutes on the same subject) and the objects and policy of the law, as indicated by its various provisions, and give to it such a construction as will carry into execution the will of the Legislature, as thus ascertained, according to its true intent and meaning." Quite recently in Ozawa v. United States, 260 U.S. 178, page 194, 43 S.Ct. 65, 67 L.Ed. 199, we said: "It is the duty of this Court to give effect to the intent of Congress. Primarily this intent is ascertained by giving the words their natural significance, but if this leads to an unreasonable result plainly at variance with the

> policy of the legislation as a whole, we must examine the matter further. We may then look to the reason of the enactment and inquire into its antecedent history and give it effect in accordance with its design and purpose, sacrificing, if necessary, the literal meaning in order that the purpose may not fail."

See also *Dewsbury* v. *U.S.*, (Ct.Cl.) 146 F. Supp. 467.

The principles of construction of statutes thus announced by this Honorable Court in the *Helvering case, supra*, clothe the petitioner herein with the constitutional right to a proper interpretation and application of Section 437(c) of the 1939 Code in the computation of its excess-profits tax liability for the years under review which does not produce a ***mathematical absurdity.***

The opinion of a majority of the Court below does not purport to construe the purpose of said section, but rather apply it as comprehending a "negative quantity" to be in the category of "equity capital" used in a trade or business; and that is done because it is said not to be "prohibited by the language of the section". Whereas, in the opinion of the minority of the Court below, such an application of the section is held to be "inherently prohibited" because of the *resulting absurdity.*

Under the science of mathematics, when a plus quantity is reduced below zero, the result is an *increase* of the "negative *quantity*" produced rather than a *reduction* thereof. Therefore, it would appear that the taxable period credit for the computation of "excess profits tax net income" subject to surtax may not be reduced by 12% of the amount by which "negative equity capital" is *increased below zero* by a distribution. When a minor quantity is *reduced*, it is made smaller; but when *increased* it is made larger, under the science of mathematics. It would be absurd to decrease the taxable period credit by 12% of the amount by which "negative equity capital" is increased by a distribution.

We submit that the minority opinion of the Court below is a proper construction and application of Section 437(c) of the 1939 Code, and should be made authoritative by a decision of this Honorable Court.

The statute gives a formula for the computation of "plus equity capital;" but it gives *no formula* for the computation of "negative equity capital." Hence, the formula for computing "negative equity capital," as applied to the business of this taxpayer, appears to be too far-fetched, under the science of mathematics, to have the sanction of the statute.

CONCLUSION

The petitioner respectfully says that the writ of certiorari should be granted for the reasons above given concerning the immediate and wide importance of the question presented.

Respectfully submitted,

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APPENDIX

PROCEEDINGS IN THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

CAUSE ARGUED AND SUBMITTED
October 15, 1958

Before: MILLER, Circuit Judge, JONES and THORNTON, District Judges.

This cause is argued by John R. Stivers for petitioner and by David O. Walter for respondent and is submitted to the court.

JUDGMENT

(Filed December 13, 1958)

On Petition to Review a decision of the Tax Court of the United States.

This cause came on to be heard on the transcript of record from the Tax Court of the United States and was argued by counsel.

ON CONSIDERATION WHEREOF, It is now here ordered and adjudged by this court that the decision of the said Tax Court in this cause be and the same is hereby affirmed.

OPINION

(Filed December 13, 1958)

No. 13,435

UNITED STATES COURT OF APPEALS
FOR THE SIXTH CIRCUIT

MID-SOUTHERN FOUNDATION,
Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

ON PETITION for Review of the Decision of the Tax Court of the United States

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Decided December 13, 1958

Before: MILLER, Circuit Judge, JONES and THORNTON, District Judges.

MILLER, Circuit Judge. The petitioner seeks a review of the decision of the Tax Court which held that the petitioner was liable for deficiencies in income taxes for the calendar years 1950 and 1951, and for the period January 1 to June 10, 1952, under the provisions of Excess Profits Tax Act of 1950 (Korean War Excess Profits Tax Act), Sections 430 to 472, Internal Revenue Code of 1939.

The facts, which were mostly stipulated, are set out in the findings of fact and opinion of the Tax Court, reported at 28 T. C. No. 102, to which reference is made. We will restate in this opinion only such basic facts as

are necessary to present the issues involved in this review. The Madison Avenue Corporation, incorporated under the laws of Tennessee, had as its principal asset the Sterick Building in Memphis, Tennessee, and was engaged in the management and leasing of office space. It filed corporation income tax returns for the years 1950 and 1951 and for the period commencing January 1 and ending June 10, 1952, hereinafter referred to as the 1952 period. The petitioner, Mid-Southern Foundation, was incorporated on June 2, 1952, under the laws of Tennessee, providing for the organization of corporations for the general welfare and not for profit. It thereafter became the owner of all of Madison Avenue Corporation's capital stock. On June 10, 1952, all the assets of that corporation were transferred to and all of the liabilities of that corporation were assumed by the petitioner. Immediately thereafter the corporate charter of the Madison Avenue Corporation was surrendered. The deficiency assessments herein involved were against the Madison Avenue Corporation, which liabilities in the amounts of $8,176.74 for 1950, $21,160.18 for 1951, and $404.99 for the 1952 period, if sustained, are legal liabilities of the petitioner as its transferee. For the purposes of this opinion, the word "taxpayer" will be used without attempting to distinguish between the two corporations.

The applicable Korean War Excess Profits Tax statute is lengthy and complex. However, the following general principles embodied therein explain its general operation and lead to the solution of the present problem.

It was the purpose of Congress in enacting this tax to reach excessive corporate profits attributable to the Korean conflict. It selected for additional tax those corporations whose profits were higher than they probably would have been in the absence of hostilities and a large military budget. In doing so, it logically uses as a tax base a different taxable income than is used for the normal tax, in order to more clearly reflect the income

attributable to the unusual, increased tempo of the economy.

After determining the normal-tax net income of the corporate taxpayer, certain adjustments are made thereto for determining the excess profits net income. These adjustments are stated in Sec. 433 (a), Internal Revenue Code of 1939, and are numerous and detailed. They include such items as credit for dividends received, exclusion of gains or losses from the sale of capital assets, and an adjustment for interest on borrowed capital. Because of the adjustments, the amount of excess profits net income for any particular year may be greater than the normal-tax net income. Such was the result in this case, as is shown by the following table, about which there is no dispute:

	1950	1951	1952 period
Normal-tax net income	$159,423.16	$147,217.39	($ 391.95) loss
Excess profits tax net income	175,896.79	179,953.57	12,415.53

From the excess profits net income is subtracted the taxpayer's excess profits credit, which results in the adjusted excess profits net income, upon which the excess profits tax is imposed. The present controversy involves the amount of the excess profits credit to which the taxpayer is entitled. It does not involve the amount of the excess profits net income, from which this credit is deducted.

Under Sec. 431 there is a minimum credit of $25,000.00. Under Sec. 434 a corporation may choose whichever of two methods of computing its credit will give it the greater amount. One method is based on the taxpayer's income during the base period years 1946-1949, which method was used in this case. In general the average base period net income is determined by computing the excess profit net income for each month in the base period, eliminating the poorest consecutive twelve months, and dividing the aggregate of the other thirty-six months by three.

Sec. 435 (a) (1), prior to amendment, provided that the excess profits credit for any taxable year should be the sum of 85 per cent of the average base period net income, plus adjustments for capital additions in the base period years, and minus 12 per cent of the net capital reduction, as defined in Sec. 435 (g) (2), for the taxable year. It will be noticed that the first item, the average base period net income, is based upon occurrences during the base period years, and represents an amount that is constant during the taxable year; the second item, being the inclusion of a percentage of the amount of base period capital additions, also represents an amount reflecting past occurrences, which remains constant during the taxable year; while the third item provides for increasing or decreasing the credit to reflect events occurring during the taxable year itself, specifically, the change in the amount of capital held for the purposes of the business. It is this third item which is in dispute in this case.

Under Sec. 435 (g) (2) and (4), the net capital reduction, being the third item above referred to, is arrived at by computing a daily capital reduction, which in turn involves "The amount, if any, by which the amount of the equity capital (as defined in Sec. 437 (c)) at the beginning of the taxpayer's first taxable year under this subchapter exceeds the amount of the equity capital at the beginning of the taxable year; * * *." This brings us to a consideration of "equity capital," which is defined in Sec. 437 (c) as, "The equity capital of the taxpayer as of any time shall be the total of its assets held at such time in good faith for the purposes of the business, *reduced* by the total of its liabilities at such time." (Emphasis added.) The proper construction of the word "reduced" is the controlling factor in the present controversy, in so far as the year 1951 and the 1952 period are concerned. With respect to the taxable year 1950, that year was also the taxpayer's first taxable year under the excess profits tax, with the result that the equity

capital at the beginning of the first taxable year under the excess profits tax was the same as the equity capital at the beginning of the taxable year 1950. Accordingly, there was no excess of the former over the latter, making Sec. 435 (g) (4) inapplicable. The year 1950 involves a different problem to which we will refer later.

The taxpayer and the Commissioner disagree with respect to the meaning and effect of the foregoing definition of equity capital. The taxpayer contends that under the foregoing definition when its liabilities exceed its assets, then equity capital ceased to exist, with the result that its equity capital was zero. It contends that its assets can under no circumstances be "reduced" below zero; that although they may be completely wiped out by liabilities in a larger amount, they are not "reduced" to a minus figure. The Commissioner contends that when liabilities exceed assets, there is created a negative equity capital, instead of a zero equity capital, being the excess of the liabilities over the assets.

Applying these contentions to the facts of the present case, we have the following situation. At the beginning of the taxable years 1950 and 1951 and the taxable period of 1952, total assets and total liabilities of the taxpayer for the purpose of computing the excess profits tax credit were in the following amounts:

	1950	1951	1952
Total assets	$1,360,950.19	$1,377,115.65	$ 981,092.56
Total liabilities	1,143,421.14	2,572,500.55	2,123,406.73

It will thus be seen that at the beginning of the taxable year 1950 the total assets exceeded the total liabilities by $217,529.05, but that at the beginning of the taxable year 1951 and the 1952 period, total liabilities exceeded total assets by the respective amounts of $1,195,384.90 and $1,142,314.17. Under these figures the taxpayer contends there is an equity capital of $217,529.05 for the year 1950 and a zero equity capital for the year 1951 and the 1952 period. Under the Commissioner's contention, there would

be an equity capital of $217,529.05 for 1950 and a minus equity capital of $1,195,384.90 for 1951 and a minus equity capital of $1,142,314.17 for the 1952 period.

The foregoing analysis of the statute shows that the only variable factor of the three factors used in determining the excess profits credit is the third one which deals with changes *during the taxable year* in the amount of capital held for the purposes of the business. The excess profits credit increases if the capital devoted to the business increases; it decreases if that capital decreases. It appears to us to logically follow that in order to correctly reflect the actual change in this capital during each taxable year, it is necessary to subtract at the start of each year the total liabilities from the total assets, and if this results in a minus figure to use such minus figure for the purpose of showing the total change. Specifically applied to the present case, we see that the taxpayer's assets on January 1, 1950, exceeded its liabilities by $217,529.05. On January 1, 1951, its liabilities exceeded its assets by $1,195,384.90. There was an actual reduction in equity capital of $1,412,913.95. Yet, if we accept the taxpayer's contention of not using a minus equity capital, there is only a reduction of $217,529.05. There was also a further change as of January 1, 1952, which would be correctly reflected, in so far as actualities are concerned, by using the minus figure, although no change at all would be reflected, contrary to the actualities, if we adopted the taxpayer's contention. We think the Commissioner's construction of the statute carries out its basic purpose of making changes in the excess profits credit so as to reflect actual changes in the equity capital from year to year. *Vol. 7A, Merten's Law of Federal Income Taxation,* p. 460, note 43.

In reaching this conclusion we have in mind that we are not compiling a balance sheet to show the net worth of the company, in which, obviously, assets become extinguished or merely zero when exceeded by liabilities. The

formula provided by the statute disregards in several ways both assets and liabilities and is not intended to reflect the net worth of the taxpayer. It is an arbitrary rule for computing a tax credit, and as such must be followed, although differing in some respects from the form and purpose of the ordinary corporate financial statement. *LaBelle Iron Works* v. *United States*, 256 U. S. 377.

Taxpayer's contention that the word "reduced" in Sec. 437 (c) should be construed as limiting the reduction to zero is, we believe, effectively met by a consideration of another section of the same statute. In Sec. 435 (f) (1), dealing with capital additions in base period and defining yearly base period capital it provides that it shall be the sum of two amounts, "reduced (but not below zero) by the sum of . . ." The addition of the words "(but not below zero)" was made by an amendment of October 20, 1951, and shows that Congress knew how to limit a reduction to zero when it wished to do so. If it was the intent of Congress to limit the reduction of equity capital by Sec. 437 (c) to zero it could readily have done so by using the same language.

Taxpayer uses what on first consideration appears to be a persuasive argument in favor of its position in contending that Congress never intended, in enacting an excess profits tax, to impose an excess profits tax on a taxpayer who was not subject in the particular tax year involved to even the normal income tax. This was taxpayer's situation for the 1952 period, where for normal income tax purposes it had a loss of $391.95, yet was being assessed in the amount of $404.99 under the excess profits tax statute. But the argument loses its force when more carefully considered. In the first place, it is applicable only to the 1952 period. For the years 1950 and 1951 taxpayer had a substantial net income for normal tax purposes of $159,423.16 and $147,217.39, respectively. In the second place, it is not directed to the

question in issue. The reason the taxpayer had an excess profits tax although it did not have a normal tax was because it had an excess profits net income, although it did not have a normal-tax income. This, in turn, was because of the different ways in which the two incomes were computed, the normal-tax income being adjusted under Sec. 433 (a) by a number of factors in order to determine the excess profits net income. There can thus legally and logically be a substantial excess profits net income although there is not a normal-tax net income. The taxpayer does not complain of this section of the statute and the effect thereof is not an issue in the case. The taxpayer's complaint is with the construction of Sec. 437 (c) which defines equity capital for the purpose of computing the excess profits credit. But it is the computation of the excess profits net income, before the credit is deducted from it, which is the real cause of the alleged unrealistic result it objects to. Keeping in mind the different tax philosophies which are responsible for the different methods of computing normal-tax net income and excess profits net income, we are of the opinion that the apparent unrealistic result is not actually unrealistic, but that it properly reflects the kind and amount of income, resulting from the unusual, increased tempo of the economy, which Congress intended to subject to a special tax, regardless of tax liability under normal conditions.

The taxpayer relies strongly upon *Thomas Paper Stock Co.* v. *Commissioner*, 22 T. C. 1294. As pointed out in the Tax Court's opinion in the present case, the issue in that case involved additions to *base period* capital which are computed under Sec. 435 (f) (2), while the present case involves the amount of capital reduction during the *taxable year*, which is computed under Sec. 435 (g) (4). For the reasons given by the Tax Court, we agree with its conclusion that the ruling in the *Thomas Paper Stock Co.* case is not in conflict with its later ruling in this case. If the two Tax Court decisions are in conflict, we are of the

opinion for the reasons hereinabove given that the later ruling is the correct one. *Louisville Property Co.* v. *Commissioner*, 140 F. (2) 547, 549-550, C. A. 6th, cert. denied, 322 U. S. 755.

We turn now to the year 1950, which involves another problem. On June 7, 1950, the taxpayer acquired and retired 4,725 shares of its own common stock, for which it paid $1,500,000.00. In computing the excess profits credit under Sec. 435, subsection (g) (4) (A) thereof provides that one of the elements to be used in computing the daily capital reduction is "Distributions to shareholders previously made during such taxable year which are not out of the earnings and profits of such taxable year; • • •". It is stipulated that in computing the excess profits credit for the year 1950, the cost of this stock is treated as a distribution made during the taxable year. The Commissioner held that the entire amount should be treated as a distribution not out of earnings and profits for the taxable year. Accordingly, it was included in computing the daily capital reduction, resulting in a smaller excess profits credit. The taxpayer contended (1) that the distribution of the $1,500,000.00 must be reduced by the 1950 corporate earnings allocable to the 4,725 shares retired, and (2) that the computations of distributions not out of earnings and profits must be limited to the amount of equity capital at the beginning of 1950. The Tax Court sustained the Commissioner. In rejecting taxpayer's contentions, it stated that its first contention was difficult to follow and could not be sustained on the evidence before it, and that with respect to its second contention, it found nothing in the language of Sec. 435 (g) (4) (A) to suggest that the amount of any distribution not out of earnings and profits was limited to the amount of equity capital at the beginning of the taxable year.

Taxpayer's brief on this review, outside of a brief factual statement presenting the issue, devotes only one

sentence to a discussion of this question, in which no reference is made to its first contention. We consider that contention to have been abandoned. *N. L. R. B.* v. *Kentucky Utilities Co.*, 182 F. (2) 810, 814, C. A. 6th. In support of its second contention it merely states that its argument against using a minus equity capital for the year 1951 and the 1952 period is equally applicable to the question of distributions to shareholders not out of earnings and profits during the taxable year 1950. Having hereinabove rejected that argument, we believe further discussion is unnecessary. We concur in the views expressed by the Tax Court on this phase of the case.

The decision of the Tax Court is affirmed.

JONES, District Judge, dissenting. I regret that I cannot join in the opinion of the majority of the court. It is my judgment that the case should be reversed for the reason, as I think, that the Commissioner, and the Tax Court affirming, misinterpreted Section 437 (c) and because I am of opinion that Section 437 (c) does not permit reduction of equity capital below zero. And, further, that the Commissioner's and the Tax Court's distinction between the present case and the Thomas Paper Stock case, 22 T. C. 1294, is not valid.